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IN THE

# Supreme Court of the United States

October Term, 1929.

No. 22

L. M. WILLCUTS, as Collector of Internal Revenue for the District of Minnesota,

*Petitioner,*

vs.

CHARLES W. BUNN.

*Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.*

## BRIEF FOR THE RESPONDENT.

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April, 1930.

## INDEX.


Page.

Statement . . . . . 1

Summary of Argument . . . . . 1

Argument:

I. The tax is illegal because it is a direct tax on income derived from municipal securities . . . . . 2

II. The tax is illegal because it is in fact an appreciable burden upon the borrowing power of the States . . . . . 6

Conclusion . . . . . 8


## TABLE OF CASES.


Page.

Choctaw Oklahoma & Gulf R. R. v. Harrison, 235 U. S. 292. 3

Eisner v. Macomber, 252 U. S. 189 . . . . . 5

Flint v. Stone Tracy Co., 220 U. S. 107 . . . . . 5

Gillespie v. Oklahoma, 257 U. S. 501 . . . . . 2, 3

Greiner v. Lewellyn, 258 U. S. 384 . . . . . 5

Macallen Co. v. Massachusetts, 279 U. S. 620 . . . . . 6

Manhattan Co. v. Blake, 148 U. S. 412 . . . . . 5

Metcalf & Eddy Co. v. Mitchell, 269 U. S. 514 . . . . . 2, 3

Plumer v. Coler, 178 U. S. 115 . . . . . 5

Pollock v. Farmers Loan & Trust Co., 157 U. S. 429, 158 U. S. 601 . . . . . 3, 4

The Collector v. Day, 11 Wall. 113 . . . . . 2

Van Allen v. The Assessors, 3 Wall. 573 . . . . . 5

Weston v. Charleston, 2 Peters 449 . . . . . 3, 4


## OTHER AUTHORITIES.


Act of June 17, 1929, Ch. 26, 46 Stat . . . . . 7

United States Daily, April 23, 1929 (P. 429 and 435); April 25, 1929 (P. 457) . . . . . 7

IN THE

# Supreme Court of the United States

October Term, 1929.

No. 535

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L. M. WILLCUTS, as Collector of Internal Revenue for the District of Minnesota,

*Petitioner,*

vs.

CHARLES W. BUNN.

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*Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.*

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## BRIEF FOR THE RESPONDENT.

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### STATEMENT.

The case is accurately stated in the brief for the petitioner.

### SUMMARY OF ARGUMENT.

The tax is illegal because:

(1) It is a direct tax upon income derived from municipal securities.

(2) It is in fact an appreciable burden upon the borrowing power of the States.

## ARGUMENT.

### I.

### The Tax Is Illegal Because It Is a Direct Tax On Income Derived from Municipal Securities.

The fundamental basis of the exemption of instrumentalities of States from Federal taxation (and vice-versa) is no doubt still the necessity of self-preservation announced in *Collector vs. Day*, 11 Wallace 113. But this Court has made it clear that there are certain instrumentalities of States so closely connected with their existence as independent governments that *any* tax upon them by the United States is void. In *Metcalf & Eddy vs. Mitchell*, 269 U. S. 514, at 524, the court said:

> "While it is evident that in one aspect the extent of the exemption must finally depend upon the effect of the tax upon the functions of the government alleged to be affected by it, still the nature of the governmental agencies or the mode of their constitution may not be disregarded in passing on the question of tax exemption; for it is obvious that an agency may be of such a character or so intimately connected with the exercise of a power or the performance of a duty by the one government, that any taxation of it by the other would be such a direct interference with the functions of government itself as to be plainly beyond the taxing power."

Where the instrumentality is of this class, exemption does not depend upon degree of burden. In *Gillespie vs. Oklahoma*, 257 U. S. 501, at 505, the court said:

> "The criterion of interference by the States with interstate commerce is one of degree. 'It is well understood that a certain amount of reaction upon and interference with such commerce cannot be avoided if the States are to exist

and make laws. New York, New Haven & Hartford R. R. Co. v. New York, 165 U. S. 628. Diamond Glue Co. v. United States Glue Co., 187 U. S. 611, 616. The rule as to instrumentalities of the United States on the other hand is absolute in form and at least stricter in substance."

"And when the instrumentality is of that character, the immunity extends not only to the instrumentality itself, but to income derived from it."

*Metcalf & Eddy vs. Mitchell*, 269 U. S. 514, at 522.

"In cases where the principal is absolutely immune from interference an inquiry is allowed into the sources from which net income is derived and if a part of it comes from such a source the tax is *pro tanto* void."

*Gillespie vs. Oklahoma*, 257 U. S. 501, at 505.

In this class fall municipal securities:

*Weston v. Charleston*, 2 Peters 449, at 468.

*Pollock v. Farmers Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601.

*Metcalf & Eddy v. Mitchell*, 269 U. S. 514, at 522, 524.

This court has not made close distinctions between income generally and the special form of income strictly known as interest. In several cases where the income was held to be exempt it was not interest at all. In *Gillespie v. Oklahoma* the tax was on the income made by a lessee from the operation of a lease. In *Choctaw & Gulf R. R. v. Harrison*, 235 U. S. 292, it was an occupation tax on gross production. And in other cases where the income was strict interest the court has generally rested the exemption on the broader ground, that it was income. *Pollock v. Farmers Loan & Trust Co.*, is of special interest because of the numerous opinions. The exemption of income from municipal securities (in particular, bonds of the

City of New York, see 157 U. S. at 583) is treated at the following pages:

Opinion of the Court, 157 U. S. at 583-586.

Opinion of Mr. Justice Field, 157 U. S. at 601-4.

Dissenting Opinion of Mr. Justice White, 157 U. S. at 652.

Dissenting Opinion of Mr. Justice Harlan, 157 U. S. at 653.

Opinion of the Court on rehearing, 158 U. S. at 618.

Dissenting Opinion of Mr. Justice Harlan on Rehearing, 158 U. S. at 666, 680.

Dissenting Opinion of Mr. Justice Brown on Rehearing, 158 U. S. at 693.

Nor has this Court made close distinctions as to the manner in which income from exempt instrumentalities is made. The principle is not that payments made by the municipality are free from tax because so paid, but that "the right to tax the contract, to any extent, when made must operate upon the power to borrow before it is exercised, and have a sensible influence upon the contract. The extent of this influence *depends upon the will of a distinct government. To any extent*, however inconsiderable, it is a burden on the operations of the government." (*Weston v. Charleston*, 2 Peters 449, at 468.)

It is therefore clearly settled that any direct tax by either government on income from the public securities of the other is prohibited. The remaining question is whether the income in this case was in fact derived from the municipal securities in question or whether it was, as claimed by the petitioner, "derived from a combination of capital, industry and skill".

A case is easy to imagine where profits from dealings in municipal securities would be within that definition. One who makes a business of dealing in securities, buying in large blocks for prompt sale at retail at a profit, may fairly be described as making income not from the securities he deals in, but from

the business he conducts. But that is not this case. Respondent is not a dealer in securities. He bought these bonds for cash, and as investments. He held them for five years (R. 2). It is very difficult in fact to assign the profit which he realized upon the sale to anything except the securities themselves. It was simply a portion of the income which he made by the investment of his capital. In *Eisner v. Macomber*, 252 U. S. 189, at 207, this Court defined "gain derived from capital" as follows:

> "*Not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being '*derived*', that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal; *that is* income derived from property. Nothing else answers the description."

Within that definition, this income was derived from the capital invested in these securities, and not from industry or labor.

*The contention that a direct tax on the income from municipal securities is void is not weakened by a demonstration that* Federal Estate Tax may be imposed on the transfer of State bonds (*Greiner v. Lewellyn*, 258 U. S. 384), or vice versa (*Plumer v. Coler*, 178 U. S. 115), or that a state may tax bank shares at a value based in part on the bank's holding of Federal securities (*Van Allen v. The Assessors*, 3 Wallace 573), or that Congress may tax banks although part of their deposits are State funds (*Manhattan Co. v. Blake*, 148 U. S. 412), or that a corporation excise tax may be measured by net income which includes interest from tax exempt securities (*Flint v. Stone Tracy Co.*, 220 U. S. 107). In all these cases the tax is on a legitimate and separate subject of taxation, and is not held

improper (subject to the limitation enforced in *Macallen Co. v. Massachusetts,* 279 U. S. 620) because part of the measure of the tax results from property which would be exempt if taxed directly. So no doubt it would be proper to impose an excise tax on the business of dealing in securities, measured by the profits of the business, although some of the securities dealt in were municipals. But that is not this case.

## II.

### The Tax Is Illegal Because It Is in Fact an Appreciable Burden Upon the Borrowing Power of the States.

It cannot be disputed that the usual inducements to an investment purchase of securities are two, the direct return in dividends or interest expected, and the hope of profit by increased value of the security itself. The second inducement is no doubt most present in the case of common stocks, but that it is absent in the case of fixed income securities is not a safe assumption. The State, like other solvent borrowers, may sell securities either at high coupon rates at par or at a premium, or at low coupon rates at a discount below par. Most private borrowers find it good business to adopt the latter plan. The reason obviously is that the certain increment of value as bonds approach maturity induces lenders to accept a lower direct interest return. Also in a time of generally high interest rates, like 1919 and 1920 when these bonds were bought or like the summer of 1929, fixed interest securities are favored by competent investors because they know that as the going rates of interest decline the value of the security itself is certain to increase. That increment in many cases can only be realized by sale. A tax upon it is a tax on a gain that the investor hopes to make by his investment. Necessarily it tends to com-

pel a higher coupon rate upon State bonds than would otherwise be needed. It is a burden on the State, only one step less direct than a tax on the interest itself.

This was the view of both the Courts below, and was quite recently the view of the Treasury Department as to Federal securities. Upon April 22, 1929, there were introduced in the Senate and House bills identical in form, prepared by the Treasury Department, and recommended by the Secretary to the Congress. Their purpose was to authorize the sale of Treasury bills, non-interest bearing, upon a discount basis. They were explained by a letter of the Secretary, and by a speech of the Under-secretary, Mr. Mills, before the American Institute of Banking (United States Daily, April 23, 1929, page 429, April 25, 1929, page 457). The full text of the bills is given in the issue of April 23, 1929, page 435. They provided in section (b) (italics ours):

> "All certificates of indebtedness and Treasury bills issued hereunder (after the date upon which this subdivision becomes law) shall be exempt, both as to principal and interest, *and any gain from the sale or other disposition thereof shall be exempt*, from all taxation (except estate or inheritance taxes) now or hereafter imposed by the United States, or by any local taxing authority."

The bills were passed in an amended form. (Act of June 17, 1929, Chapter 26, 46 Stat. —). The words italicized above were omitted, and it was provided that "the amount of discount at which Treasury bills are originally sold by the United States shall be considered to be interest within the meaning of this subdivision". But the form in which the bills were prepared by the Treasury Department demonstrates its expert view that taxation by the States on the profits made by sale of Federal securities would affect adversely the excellent mar-

ket which such securities command. The burden works both ways, and if this conclusion of the Treasury was right it follows that Federal taxation of gains made on sale of municipal securities is a burden on the States. As such, it is invalid.

## CONCLUSION.

It is therefore respectfully submitted that the judgment of the Courts below was right, and should be affirmed.

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April, 1930.